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BUREAU OF INTELLIGENCE & RESEARCH
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CHINA LIGHTS

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I. TAIWAN: DEMOCRATIZATION BY DESIGN (3/19, updated 3/28)

After a year of careful preparation, and contrary to the wishes of some once-powerful mainlander politicians, Taiwan is poised to amend its constitution to make it more democratic and consistent with political reality. The challenge is to shift power from elderly mainlanders to the Taiwanese majority without discrediting the ruling Kuomintang (KMT). Advocates and opponents of Taiwan independence will become more vocal, but President Lee Teng-hui's drive for cautious yet meaningful change is likely to prevail.

Last spring President Lee proclaimed mainland-policy revision and constitutional reform his two highest goals. Lee's National Unification Council has just announced new "reunification" guidelines to improve cross-strait ties; the president will turn now to constitutional reform. By dealing first with mainland policy, Lee hopes to reassure both Beijing and elderly KMT figures that constitutional reform is not a ploy for independence.

Reform timetable and content

The KMT constitutional-reform plan envisages a cumbersome two-stage process stretching through mid-1992. The National Assembly, dominated by "old thieves" elected on the mainland in 1947, meets on April 8 to launch the procedural stage. It will abolish the "temporary provisions" that suspended normal constitutional provisions during "the period of communist rebellion," authorize interim presidential powers and election of a reapportioned assembly, and consider constitutional changes.

A new assembly of prospectively 327 seats, including a majority of members representing Taiwan districts, 80 "at large" members and 20 seats reserved for overseas Chinese representatives, would be elected this winter and meet in early 1992 to amend the constitution. The more important Legislative

Yuan will be reapportioned to increase representation from Taiwan province (though retaining vestigial "China" seats); the Taiwan governor and major city mayors will--for the first time--be directly elected; and the president will be given new, as yet undefined, powers. An unresolved question is whether the president--next up for re-election in 1996--will be elected directly or indirectly.

Taiwan for the Taiwanese

After reforms, representative bodies and most important officials will be elected directly by Taiwan's people--a transformation with important implications for a possible future shift from Taiwan's announced goal of reunification. But democratization and Taiwanization will probably not bring early change to Taiwan's mainland policy. Given the delicacy of Taiwan's position in relation to the PRC, both the KMT and most of the opposition agree that caution and stability are needed so as not to upset Beijing. And the KMT will remain in control; despite some Taiwanization of the party, the weight of mainlanders in KMT central organs means that KMT politicians must balance Taiwanese and mainlander concerns.

Few obstacles to reform

Opposition Democratic Progressive party (DPP) politicians, excluded from reform planning, may mount protests, but continued disunity will weaken the party's clout. Though some KMT elders in the assembly threaten to ignore party discipline, they pose little obstacle to reform. Elections may leave the KMT with less than the 75% majority needed to pass constitutional amendments in the new assembly, but it should be able to gain votes by making concessions to independents and moderate DPP members. Reform could be stalled by a KMT crackdown against protests launched by pro-independence opposition radicals, but KMT restraint to date argues against such a worst case. (MFinegan) (CONFIDENTIAL)

II. CHINA: WARILY WATCHING WESTWARD (3/21)

Chinese leaders are worried the coalition victory in the Gulf will foster US global "hegemony," and that China will be a target of stepped-up US pressure. But this worry is balanced by rising Chinese concerns about regional stability and the implications for China's ethnic minorities--especially its 16 million Moslems--of ethnic assertiveness in the USSR and of the spread of pan-Islamic and fundamentalist sentiment along China's borders.

Beijing has in the past predicated its policies toward south and west Asia and the Middle East on its fear of encirclement by a strong and hostile Soviet Union and by India

and Vietnam, Moscow's "proxies." The erosion of the underpinnings of China's traditional policies had become apparent before the Gulf crisis. [redacted] B1

Peaceful borders

China's fear of Soviet encirclement has largely given way to concern about regional stability and the influence on China's restive minorities of developments along its borders, including the effect of political activism and religious revivalism among Soviet Moslems on the millions of Uighurs, Kazaks, and other groups that straddle the Sino-Soviet border. Last April the governor of Xinjiang, which has a long and relatively porous border with the Soviet Union, accompanied Premier Li Peng to Moscow to discuss cross-border issues.

Concerned about long-term instability in Afghanistan after the Soviet withdrawal and the possibility of a fundamentalist regime on China's western doorstep, Beijing is calling for a political settlement, has ended military support to the resistance, and late last year even provided a small amount of humanitarian aid to the Kabul regime. [redacted] B1

Pragmatism in South Asia

Worried about instability in the Indian subcontinent, Beijing has called on New Delhi and Islamabad to settle the Kashmir dispute peacefully. Progress in relations with India--including movement toward a settlement of the long-standing border dispute--has been halting mainly because of political turmoil in New Delhi. Beijing now is waiting until after India's elections for a trip to India by Premier Li Peng, apparently expecting Gandhi will return to power. But Beijing has already begun to put relations with Pakistan on a more "pragmatic" and "businesslike" basis [redacted] B1

Though Sino-Pakistani relations--including military ties--are and will remain close, Beijing may be imposing limits. [redacted] B1

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[redacted] (CClarke)
(SECRET/NOFORN/NOCONTRACT/ORCON/EXDIS)

III. CHINA: FOURTH EXPANSION UNDER WAY (3/20)

China's economy once again is poised for rapid, inflationary growth. As the economy heats up, import demand will swell--especially for construction materials, current inputs, and capital goods. But the US trade deficit with China is unlikely to shrink. Southern Chinese firms and Hong Kong re-exporters will focus even more on the United States owing to government inducements to boost sales, and restrictions and poorer market prospects elsewhere. Soft credits offered by competitors will disadvantage US sellers of capital goods and services, and farm exports--a staple of US-China trade--will fall, according to USDA.

Since reform began in the late 1970s, China has experienced three cycles of macroeconomic instability: 1979-82, 1984-86, and 1986-90. Recent IMF investigation of these cycles describes a sequence of excessive credit expansion, rise in inflation, deterioration of the balance of payments, and contraction in growth following application of harsh administrative restraints to reduce excess demand. As the scope of reform widened during the 1980s, the amplitude of price fluctuations increased significantly, and, as the share of foreign trade rose, current-account deficits peaked substantially higher than in the first cycle.

Stage is set . . .

China's economy last year grew much faster than officials had forecast, mainly because of an unexpectedly buoyant fourth quarter and a larger than estimated harvest. GNP rose 5% (two percentage points higher than expected), according to China's statistical bureau. Industrial production, sluggish early in the year, increased 7.6%--led by light industry, up over 9%. Farm output rose 6.9%. China's grain harvest was a record 435 million tons, and livestock production increased almost 6%.

Inflation eased quickly last year; retail prices rose only 2.1% as a result of austerity policies adopted in 1988-89, administrative price caps, and higher price subsidies. Real average wages of urban workers, which are loosely linked to production, climbed almost 10%. Retail sales--depressed most of the year--recovered in the fourth quarter owing to higher incomes and a lower real interest rate paid on personal savings.

Despite the rally in production, fiscal results remained poor. More firms lost more money--particularly larger state-owned enterprises; the Chinese report that profits of state firms fell 58%, compared with 1989. Inventories rose, and problems with quality suggest that too much of it is unsalable except at scrapping prices. Though budget results have not yet been reported, the government's deficit was higher than planned.

. . . for next boom-bust cycle

The central government began late in 1989 to engineer the recovery in industrial production by relaxing credit restraints and reducing interest rates on bank loans. Even so, successive increases in the credit ceiling imposed on the banking system were needed to jump-start the economy. Bank loans in 1990 rose by 22%.

Credit expansion is reflected in increased producer demand. Even though Chinese statistics show investment in fixed assets last year rose only 4.5%, investment by state-owned firms--which account for about two-thirds of fixed investment--increased 10.5% because the government skewed lending to favor the state sector. Credit expansion also is reflected in the rise of the money supply; broad money--currency, sight deposits, and time deposits--rose nearly 29% (seasonally adjusted).

Recent IMF statistical research has established changes in broad money as a leading indicator of changes in China's rate of inflation. Trends in the money supply since late 1989 strongly suggest that resumption of inflation is imminent. Chinese officials are concerned and have told Embassy Beijing that bank credit will be tightened this year. Government and enterprise fiscal problems, however, are likely to cause officials to increase credit rather than reduce it.

Implications for trade

Higher aggregate demand this year should boost imports, especially of producer goods, and cause China's trade surplus to decline substantially from the $13 billion posted last year. Even if government controls on imports remain relatively firm, export growth should slow as goods are diverted to the domestic market and inflation erodes China's price competitiveness.

US sales to China will rise as industry resumes fast-paced growth. But China's sales to the United States also should increase rapidly, if MFN remains available, because of rising value-added in textiles and a growing grip on markets for low-cost consumer goods, especially toys. The US deficit--$10.5 billion in 1990, according to Commerce Department figures--probably will widen this year by $2-to-$4 billion. (WNewcomb/INR/EC) (CONFIDENTIAL)

IV CHINA: REEVALUATING THE LESSONS OF THE GULF CRISIS

Chinese leaders, ill-served by poor [redacted] analysis of the Gulf situation, are now reevaluating the lessons of the coalition victory. Politically, worries remain high that a "hegemonistic" US will increase pressure on China. Militarily, Beijing fears its "people's war" strategy, dated armaments, and low quality manpower and training are a poor match for Western high technology and air superiority. B1

Finger pointing on China's "intelligence failure" has already begun. But leaders are also taking steps to try to improve the PLA's readiness. Chinese media, for example, are highlighting the allegedly unprecedented scale of nationwide military exercises ordered last December by Military Commission Chairman Jiang Zemin. The exercise schedule has, in fact, been stepped up, but foreign--especially Taiwan and Hong Kong--media commentary appears to have overstated the level of military training activity. The PLA's budget is also being increased significantly for the second year in a row; the overt budget in 1991 will rise more than 12 percent in nominal terms, following more than a 15 percent rise last year. An increase was already in the works before the Gulf war broke out, but subsequent PLA pressure for better equipment and more high-tech research may have boosted the spending increase somewhat.

From the outset, top leaders paid close attention to the Gulf situation. [redacted] Advisors initially expected the coalition to get bogged down in a protracted land campaign, resulting in the fraying--and eventual collapse--of the coalition. [redacted] B1

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An "intelligence failure"

[redacted] B1

DECLASSIFIED [redacted] B1

Chinese leaders apparently expected a protracted conflict to result in a windfall for the PLA. [redacted] B1

Getting the picture

Though ill-served by official assessments, top leaders personally monitored the situation, thus gradually coming to grips with the enormity and success of the US and allied effort. [redacted] B1

Getting "smart"

After the ceasefire, political commissars initially sought to dismiss Saddam's defeat as the result of poor morale; increasingly, however, Chinese military analysts are drawing hard conclusions about PLA modernization.

--A challenge. [redacted] B1

--Tactical adjustments. Initial post-war assessments also point to doctrinal and tactical lessons, including the importance of air superiority, mechanization, electronic warfare, and technical means of intelligence collection in determining the outcome of ground campaigns. [redacted] B1

--Man--"the decisive factor". Professionals agree with commissars that personnel deficiencies are a major stumbling block to PLA modernization, but disagree about

the cause. Commissars have stepped up indoctrination against defeatism or demoralization following the US' demonstration of its prowess. But professionals are focusing on the need for more highly trained and better educated manpower. They also focus on structural improvements such as better reserve, logistics, and rapid-deployment forces.

Political fallout.

Early in the hostilities, Beijing ordered domestic media to accord minimal coverage to the Gulf out of fear pro-American sentiment might result in demonstrations--and probably concern that China's military weakness could be further exposed to the public. [redacted]

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Finger pointing

Blame casting for China's "intelligence failure" in the Gulf has also begun. [redacted] There is more than enough blame to go around in Beijing, however, with virtually all civilian and military advisory agencies having taken the same analytical line.

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(CClarke)
(SECRET/NOFORN/NOCONTRACT/ORCON/EXDIS)

V. BEIJING'S THREE-LEGGED RACE - THE CONSERVATIVE REFORM PROGRAM

Faced with an economy seemingly headed into a period of rapid growth and inflation, China's conservative leaders, including Premier Li Peng, are articulating a comprehensive strategy that defies simple description as "reformist" or "conservative." The strategy involves balancing three key objectives-- development, reform, and stability--all of which are viewed as essential to the long-term and oft-articulated goal of improving economic efficiency by combining elements of planning and market forces.

This program involves the license for provinces to experiment with changes in China's unwieldy welfare and subsidized housing systems that, if pursued extensively, could represent real and significant reforms. Further price reforms, including both periodic adjustments and freeing some prices to the market, are also part of the new consensus program, although price changes will be carefully modulated and staggered. Welfare, housing, and price reform initiatives are fragile, however. Signs that stability--whether political, economic, or social--is threatened will almost certainly result in a halt of, or retreat from, envisioned reforms.

The conservative program, however, also involves deliberate preservation of some economically inefficient aspects of Soviet-style economic planning and traditional Chinese organization. Beijing's current leadership is willing to tolerate these inefficiencies in the interest of preserving political, economic, and social stability as well as a measure of ideological orthodoxy. At the same time, the central leadership lacks the clout to change key elements of the existing system that are widely recognized by "conservatives" and "reformers" alike as retarding progress, including the bargaining nature of contracts between state and enterprise or center and province, local political influence over the banking system, and the irrational and inadequate tax system.

Taking them seriously

China's conservative economic thinkers and administrators have long articulated a vision of a "socialism with Chinese characteristics" that would, in the current parlance, involve a "socialist planned commodity economic system and operating mechanisms which combine planned economy and market mechanisms." They take each of these elements seriously; speeches at the February 28-March 1, 1991 Commission for Restructuring the Economic System (CRES) conference on the future of reform helped clarify how conservative leaders view the various elements of this slogan. Chen Jinhua, newly appointed minister in charge of reform, laid out a clear five-point list of objectives:

--Ownership - "Socialist public ownership" should remain the "dominant force" in the economy, but diverse forms of ownership should be allowed. Chen did not specify how the public sector should be "dominant," but he seemed to imply that state control over the Leninist "commanding economic heights"--e.g., major heavy industry, banking, and transport--would be the principal criterion rather than the percentage of GNP or industrial output accounted for by the state sector. His comments, and Li Peng's, suggest current leaders envision a streamlined centrally-controlled state sector.

--Management - Except for a small number of protected industries--presumably mainly defense-related--all enterprises should be made competitive and responsible for their profits and losses. They should become "commodity producers," responsive to market signals.

--Markets - Only a few prices for goods and services vital to the national economy should be set by the state. The rest should respond to market signals, subject to macro-policy guidance by the government.

--Decentralization - Regulation and control over the economy should fall principally to provincial and municipal officials, with the central government setting only broad policy parameters.

--Remuneration - Incomes should be determined principally by the work performed, although "unearned" forms of income--including such "capitalist" mechanisms as stock dividends--should also be allowed.

The three-legged race

Premier Li Peng, in his keynote address to the reform conference, laid out his strategy for accomplishing the objectives described by Chen Jinhua. Li's strategy involves a complex balancing act revolving around the relationship of

development, reform, and stability. In Li's words, "The purpose of reform is development, and development depends on reform. Sometimes, however, reform is subject to stability as a prerequisite."

Development. Li's "development" is a socialist, planned development in which the government creates the necessary environment for large and medium-sized state industries to flourish. This, in Li's view, entails both creating the necessary external conditions for state industry--priority credit and raw material supplies, price controls, tax and other incentives for technical upgrading, and favorable regulatory frameworks--and improving the internal workings of state enterprises to make them more efficient and responsive to market and policy signals. These improvements would include such traditional conservative ideas as consolidations, mergers, and reorganizations to strengthen corporate management over resources, but also leave latitude for experimentation with ownership reforms, even in state industry.

Reform. Li and other conservative spokesmen have begun in recent months to articulate a willingness to push forward with a number of significant reforms that they believe will enhance the center's ability to promote socialist development and strengthen state enterprises. These reforms include allowing limited stock issuance in some state firms. Such experiments are viewed both as a method to raise needed funds and improve incentives for efficient management. Li, at the recent reform conference, however, clearly demarcated the boundaries of such experimentation: shareholding in state enterprises "should be conducive to the consolidation of the socialist ownership system and the development of productive forces [i.e., the state should retain control and not privatize most government-owned enterprises]. Moreover, the experimental work in this respect should be carried out in a safe, reliable way, and no attempt should be made to rush headlong into a mass action."

At the same time, Li sanctioned plans for wide-ranging reforms in a number of other areas, including housing, welfare benefits, and medical care. These three areas are major points of public disatisfaction, significant drains on the central budget, and roadblocks to accomplishing broader-scale systemic reforms such as implementing existing bankruptcy legislation. Li's calculation in moving ahead with reform in these areas reflects a commitment to improving economic efficiency and reducing the central budget deficit as well as a recognition of existing political realities.

By licensing further experimentation with housing, welfare, and medical reforms, Li can be seen to be responding to Deng Xiaoping's 1989 injunction to "do something for the people" and burnish his credentials as a "reformer." At the same time, he can deflect criticism for unpopular side effects of the reforms onto local officials, who will be responsible for devising,

implementing, and funding actual programs. Moreover, with the conservatives' strenuous efforts in 1988-89 to recapture control over authority and economic resources from the provinces largely having failed, Li and the central government seem to have resolved to devolve program and financial responsibility for the budget-busting housing, welfare, and medical care programs onto the localities and individual beneficiaries.

If implemented, decentralization of housing, welfare, and medical care could represent a significant reform of the Chinese system; it is certain to result in greater diversity across the country. In many localities, these reforms may further weaken the stranglehold of the danwei (work unit) over the employee. De-linking housing, unemployment insurance, retirement benefits and pensions, and medical insurance from employment could lead to far more labor mobility, marketization of housing, and more forceful implementation of bankruptcy regulations, at least in selected localities.

Stability. Li, in his speech to the reform conference, argued that "economic, political, and social stability in our country have provided the prerequisite for us to further improve reform and increase our reform efforts." This new-found commitment to speeding up reform appears to be a response to several stimuli: Deng's pressure, the imperative of cleaning up his political and public image as the succession draws nearer, widespread consensus among reform and moderate economists that the successes of the austerity program have opened a window of opportunity for reform that ought not to be wasted, and a growing concern among both reformers and conservatives about the potential costs of not implementing near-term reforms as the economy is beginning to heat up and may be headed for another round of inflation later this year.

But Li also made it clear that progress on reforms of the housing, medical, and welfare systems will depend on the public's ability to tolerate pain. Conducting reform, according to Li, should not only "properly handle the relationship between the interests of the state, collectives, and individuals," but must "take into full consideration their capacities to withstand the stress of reform."

Zhao-ism without Zhao? Much of what "conservatives" like Li Peng are advocating today harks back to the "reformers'" agenda of the mid- and late-1980s. There are, however, at least two crucial differences between Zhao Ziyang's approach and Li Peng's. One crucial difference involves the end envisioned: Zhao, or at least many of his young economic and political advisers, saw the goal of reform as establishing a market economy presided over by an authoritarian political leadership, in short, rebuilding China along the lines of South Korea, Taiwan, and Singapore. Li Peng and most other current leaders believe in the preservation of a strong socialist, state sector.

Another crucial difference between Zhao's program and that of Li Peng concerns risk aversion. Zhao and his advisers believed that greater confusion and pain in the short-term would solve most of China's problems over the long term; they were confident they could contain or handle the negative spin-offs of the reforms as they emerged. Li and most other current leaders are far more fearful of the downside of mistakes and far less confident--especially after Tiananmén--that risks associated with bold and rapid reform are manageable. As a result, implementation of the conservatives' reform program is likely to be halting and tentative as leaders constantly gauge the public mood. If the economy experiences another troubled period this summer, Beijing may call an early recess to further potentially destabilizing experimentation. (CClarke) (CONFIDENTIAL)